



TAX EXEMPT AND
GOVERNMENT ENTITIES
DIVISION

DEPARTMENT OF THE TREASURY
INTERNAL REVENUE SERVICE
WASHINGTON, D.C. 20224

Release Number: **201431031**
Release Date: 8/1/2014
Date: May 6, 2014
UIL: 501.12-00, 501.12-02

Contact Person:
Identification Number:
Contact Number:
Employer Identification Number:
Form Required To Be Filed:
Tax Years:

Dear :

This is our final determination that you do not qualify for exemption from Federal income tax as an organization described in Internal Revenue Code section 501(c)(12). Recently, we sent you a letter in response to your application that proposed an adverse determination. The letter explained the facts, law and rationale, and gave you 30 days to file a protest. Since we did not receive a protest within the requisite 30 days, the proposed adverse determination is now final.

You must file Federal income tax returns on the form and for the years listed above within 30 days of this letter, unless you request an extension of time to file. File the returns in accordance with their instructions, and do not send them to this office. Failure to file the returns timely may result in a penalty.

We will make this letter and our proposed adverse determination letter available for public inspection under Code section 6110, after deleting certain identifying information. Please read the enclosed Notice 437, *Notice of Intention to Disclose*, and review the two attached letters that show our proposed deletions. If you disagree with our proposed deletions, follow the instructions in Notice 437. If you agree with our deletions, you do not need to take any further action.

If you have any questions about this letter, please contact the person whose name and telephone number are shown in the heading of this letter. If you have any questions about your Federal income tax status and responsibilities, please contact IRS Customer Service at

1-800-829-1040 or the IRS Customer Service number for businesses, 1-800-829-4933. The IRS Customer Service number for people with hearing impairments is 1-800-829-4059.

Sincerely,

Tamera Ripperda
Director, Exempt Organizations
Rulings and Agreements

Enclosure
Notice 437
Redacted Proposed Adverse Determination Letter
Redacted Final Adverse Determination Letter



TAX EXEMPT AND
GOVERNMENT ENTITIES
DIVISION

DEPARTMENT OF THE TREASURY
INTERNAL REVENUE SERVICE
WASHINGTON, D.C. 20224

Date: April 2, 2014

UIL: 501.12-00, 501.12-02

Contact Person:

Identification Number:

Contact Number:

FAX Number:

Employer Identification Number:

Dear :

We have considered your application for recognition of exemption from Federal income tax under Internal Revenue Code § 501(a). Based on the information provided, we have concluded that you do not qualify for exemption under Code § 501(c)(12). The basis for our conclusion is set forth below.

FACTS

You are incorporated under your State's Utilities Code law as a telephone cooperative. Your State Utilities Code provides that telephone cooperatives operate a nonprofit basis for the mutual benefit of its members and patrons. You filed Form 1024, *Application for Recognition of Exemption Under Section 501(a)*, seeking recognition as an organization "like" a mutual or cooperative telephone company under § 501(c)(12).

Your Articles of Incorporation provide that you "formed for the purpose of furnishing communication services and any and all other purposes for which a telephone cooperative corporation may be formed." Specifically, you facilitate communication services by providing gateway and policy control services to your members, which are companies that provide telecommunication services, such as cellular and internet services, to the public. Your gateway service provides your members with affordable access to the worldwide 4G broadband network. You state that, without the gateway, your members would be unable to provide access to the 4G broadband network and therefore would be unable to provide broadband (i.e., internet) to their customers. Your policy control service manages the traffic through your gateway so that your members' customers receive optimal usage of the network. In other words, your policy control service ensures that your members' customers receive the fastest connect times at the best quality possible with current technology.

Membership

You state that your members must provide telephone or communications services or be a wholly owned subsidiary or controlled affiliate of an entity providing telephone or communications services. Your members must pay a one-time membership fee, agree to

comply with and be bound by your Articles and Bylaws, and be accepted for membership by your Board of Directors. You have four membership classes:

- Founding Members are those members that created you and invested the initial capital and infrastructure necessary to carry out your services;
- Charter Members are those members that committed to becoming Full Members prior to a certain date;
- Full Members are those members who have paid a membership fee, dues, and pro rata costs necessary to entitle them to participate in your services; and
- Associate Members are members that participate only in select services.

You state that, in the future, you may create additional membership classes. Currently, you have a total of four Full Members. Three of these members are also your Founding and Charter Members. You have no Associate Members at this time.

Termination of membership may be voluntary or involuntary. Your Bylaws provide that termination of any kind releases the member of all right, title, and interest in your property and assets.

Operation at Cost

Each Full Member must pay a one-time membership fee of \$1x. Additionally, each month, every member pays a fixed fee of \$3.5x and a variable usage fee for provision of gateway and policy services. You state that you will adjust the variable usage fee quarterly to ensure that you have sufficient cash to cover your expenses.

You provide capital credits to your members for amounts received in excess of operating costs and expenses. You allocate these credits on a pro rata basis in proportion to the member's business with you (patronage basis). At the Board of Director's discretion, you may allocate non-operating and nonmember income in excess of costs and expenses to your members' capital accounts on a patronage basis. Any distribution from the members' capital accounts is at the Board of Director's discretion. You intend to keep appropriate books and records and will report to each member the amount of capital credited to its account each fiscal year. Distributions from your members' capital accounts are at the Board of Director's discretion.

Governance

You conduct annual membership meetings. At least one-half of the total members must be present at the annual meeting to constitute a quorum. You do not permit your members to vote by proxy. Each Full Member is entitled to one vote upon each matter submitted to a vote at a meeting of the members. Founding, Charter, and Associate Members are not entitled to vote.

Each of Founding Members elects two of your six directors. Your Board of Directors, in turn, elects its officers "by and from the Board of Directors." Full, Charter, and Associate Members are not entitled to elect or appoint directors or officers. Nonetheless, Full Members may remove a director with a petition signed by the majority of all the Full Members.

Income

You state that, currently, member income is your sole source of income. In the future, you anticipate some interest income. Additionally, you state that you will account for any income received from Associate Members as nonmember income. However, you do not anticipate either income source to exceed 15 percent of your total income.

LAW

I.R.C. § 501(c)(12) provides for the exemption of benevolent life insurance companies of a purely local character, mutual ditch or irrigation companies, mutual or cooperative telephone companies, or like organizations, but only if 85 percent or more of the income consists of amounts collected from members for the sole purpose of meeting losses and expenses.

Treas. Reg. § 1.501(c)(12)-1(a) states that an organization described in § 501(c)(12) must receive at least 85 percent of its income from amounts collected from members for the sole purposes of meeting losses and expenses. If an organization issues policies for stipulated cash premiums, or if it requires advance deposits to cover the cost of the insurance and maintains investments from which more than 15 percent of its income is derived, it is not entitled to exemption. On the other hand, an organization may be entitled to exemption, although it makes advance assessments for the sole purpose of meeting future losses and expenses, provided that the balance of such assessments remaining on hand at the end of the year is retained to meet losses and expenses or is returned to members.

Rev. Rul. 57-420, 1957-2 C.B. 308, determined that an organization that provided and maintained a two-way radio system for its members on a mutual or cooperative basis qualified for recognition under § 501(c)(12). The two-way radio association was similar to a mutual or cooperative telephone company in that a two-way radio communication system on a mutual basis is an organization whose purpose is similar in nature to a mutual telephone company. Accordingly, the organization qualified for recognition under § 501(c)(12) as a "like" organization.

The Service has determined that End User Internet Service Providers (End User ISPs) provide a service similar to the two-way radio system held to be exempt in Rev. Rul. 57-420, and therefore qualify for exemption under § 501(c)(12), subject to certain conditions set forth in revenue ruling below.

Rev. Rul. 72-36, 1972-1 C.B. 151, sets forth certain requirements cooperative companies must meet for exemption under § 501(c)(12).

1. The rights and interests of the members in the savings of an organization should be determined in proportion to their business with the organization. The interests of members in the savings of the organization may be determined in proportion to either the value or the quantity of the services purchased from the organization, provided such basis is realistic in terms of actual cost of the services to the organization.
2. Funds retained in excess of those currently needed for such purposes as retiring indebtedness incurred in acquiring assets, expanding the services of the organization, or maintaining reserves for necessary purposes must be reasonable in light of the

organization's business needs. Whether there is an improper accumulation of funds depends upon the particular circumstances of each case.

3. The organization's records must show each member's rights and interests in the funds it retains.
4. A member's rights and interest cannot be forfeited upon dissolution or termination.
5. Upon dissolution, gains from the sale of an appreciated asset should be distributed to all persons who were members during the period which the asset was owned by the organization in proportion to the amount of business done by such members during that period, insofar as is practicable.

Rev. Rul. 2002-55, 2002-2 C.B. 529, determined that a telephone cooperative that received 90 percent of its income from its members for telephone services satisfied the 85 percent member income test. The 85 percent member income test requires a cooperative exempt under § 501(c)(12) for any taxable year to combine all sources of income not otherwise excludable under § 501(c)(12)(B) or (C) and calculate whether more than 15 percent of that income is derived from nonmembers. In the year in question, the organization received \$90x from its members for telephone services, \$5x as a dividend from a wholly owned taxable subsidiary, and \$5x interest income. Accordingly, the organization met the 85 percent member income test for the year in question.

In Puget Sound Plywood, Inc. v. Commissioner, 44 T.C. 305 (1965), *acq.* 1966-1 C.B. 3, the Tax Court stated that an organization must meet certain common law requirements in order to be a cooperative, which include: (1) democratic control of the organization by members; (2) operation at cost for the benefit of the members; and (3) the subordination of capital.

RATIONALE

An organization seeking exemption under § 501(c)(12) must satisfy three requirements. First, it must be organized and operated as a cooperative (the "organizational and operational tests"). Second, it must conduct activities described in § 501(c)(12) (the "activities test"). Finally, it must derive at least 85 percent of its income from members solely for the sole purpose of meeting expenses and losses (the "income source test"). You request recognition under § 501(c)(12) as an organization "like" a mutual or cooperative telephone company. However, the materials submitted indicate that you do not qualify for recognition under § 501(c)(12).

1. Organization and Operational Test

Although you are organized as a cooperative telephone company under your State law, you are not operated as such. An organization meets the requirements of the organizational and operational tests if it is organized and operated under both the common law definition and the requirements of Rev. Rul. 72-36. Under the common law, a cooperative organization exhibits three characteristics: (1) democratic control by the members; (2) operation at cost; and (3) subordination of capital. Puget Sound Plywood, Inc. v. Commissioner, 44 T.C. 305 (1965), *acq.* 1966-1 C.B. 3. Additionally, a cooperative organization must meet the five requirements of Rev. Rul. 72-36.

You are not a cooperative within the common law definition because your operations do not illustrate subordination of capital. In Puget Sound Plywood, the Tax Court stated that "implementation of the subordination of capital as regards control over the management and direction of the cooperative, is achieved through bylaw provisions which vest in the members themselves the right and power to elect the trustees and the officers of the cooperative." Your Bylaws vest the right and power to elect your directors solely in your Founding Members; Charter, Full, and Associate Members retain no right or power to elect directors. Furthermore, the power to elect officers is vested solely in the Founding-Member-elected board of directors; no membership class retains the right to elect officers. Accordingly, control over your management and direction is vested in only part of your membership. Additionally, you fail to meet the requirements of Rev. Rul. 72-36 because your members forfeit their rights and interests upon termination of membership. Therefore, you are not a cooperative organization within the meaning of § 501(c)(12).

2. Activities Test

You do not perform activities "like" a mutual or cooperative telephone company under § 501(c)(12). The term "like" is limited by the type of organizations specified in § 501(c)(12). Organizations that are "like" mutual or cooperative telephone companies facilitate communication between members and others. Rev. Rul. 57-420 (two-way radio service). Accordingly, organizations (End User ISPs) that provide internet or broadband services on a mutual or cooperative basis usually qualify for recognition under § 501(c)(12). However, you do not provide internet or broadband to your members. Rather, you provide a "gateway" through which your members—other telecommunications companies—access the worldwide 4G broadband network. This access allows your members to provide broadband services to their customers. Nothing in your materials indicates that your operations facilitate communication between your members and others. Rather, your operations facilitate communication between your Members' customers (i.e., nonmembers) and others. Therefore, you are not a "like" organization within the meaning of § 501(c)(12).

3. Income Source Test

You failed to establish that you receive at least 85 percent of your income from your members for the sole purpose of meeting income and expenses. The 85 percent member income test requires an organization exempt under § 501(c)(12) for any taxable year to combine all sources of income not otherwise excludable under § 501(c)(12)(B) or (C) and calculate whether more than 15 percent of that income is derived from nonmembers. Rev. Rul. 2002-55. A "member" is an individual who has the right to elect the governing board of the cooperative and be involved in the operations of the organization. Puget Sound Plywood, 44 T.C. 305. In this case, your Full, Charter, and Associate Members are not "members" within the meaning of § 501(c)(12) because these membership classes are not entitled to elect or appoint officers or directors. Additionally, Founding, Charter, and Associate members are not entitled to vote at membership meetings. Nonetheless, your Founding Members may vote at membership meetings because your Founding Members are also Full and Charter Members. Currently, you have one Full Member that is not also a Founding or Charter Member and no Associate Members. You do not state how much income you receive from this member. Accordingly, you may receive nonmember income in excess of 15 percent.

CONCLUSION

You do not qualify for recognition as a mutual or cooperative telephone company or "like" organization under § 501(c)(12).

You have the right to file a protest if you believe this determination is incorrect. To protest, you must submit a statement of your views and fully explain your reasoning. You must submit the statement, signed by one of your officers, within 30 days from the date of this letter. We will consider your statement and decide if the information affects our determination.

Your protest statement should be accompanied by the following declaration:

Under penalties of perjury, I declare that I have examined this protest statement, including accompanying documents, and, to the best of my knowledge and belief, the statement contains all the relevant facts, and such facts are true, correct, and complete.

You also have a right to request a conference to discuss your protest. This request should be made when you file your protest statement. An attorney, certified public accountant, or an individual enrolled to practice before the Internal Revenue Service may represent you. If you want representation during the conference procedures, you must file a proper power of attorney, Form 2848, *Power of Attorney and Declaration of Representative*, if you have not already done so. For more information about representation, see Publication 947, *Practice before the IRS and Power of Attorney*. All forms and publications mentioned in this letter can be found at www.irs.gov, Forms and Publications.

If you do not intend to protest this determination, you do not need to take any further action. If we do not hear from you within 30 days, we will issue a final adverse determination letter. That letter will provide information about filing tax returns and other matters.

Please send your protest statement, Form 2848 and any supporting documents to this address:

Internal Revenue Service

1111 Constitution Ave, N.W.
Washington, DC 20224

You may also fax your statement using the fax number shown in the heading of this letter. If you fax your statement, please call the person identified in the heading of this letter to confirm that he or she received your fax.

If you have any questions, please contact the person whose name and telephone number are shown in the heading of this letter.

Sincerely,

Michael Seto
Manager, EO Technical